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LFC INVESTMENT REPORT FOR THE QUARTER ENDING SEPTEMBER 30, 2012

This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). It explains how the returns generated by the three investment agencies differed from that of the archetypical fund and how their management and consultants added or subtracted value. Although the attribution analysis included in this report concentrates on the quarter, long term performance is indeed the most important metric. Therefore this report shows fund returns and comparative rankings for the one-year, three-year and five-year periods as well.

In contrast to the second quarter, the third quarter of 2012 saw stocks rally, with most equity markets yielding gains despite slow economic growth and weaker-than-expected job growth. U.S. stocks showed improvement, with the S&P 500 returning 6.35%. In spite of continued turmoil and poor economic news, most global equity markets rallied in the third quarter as well.

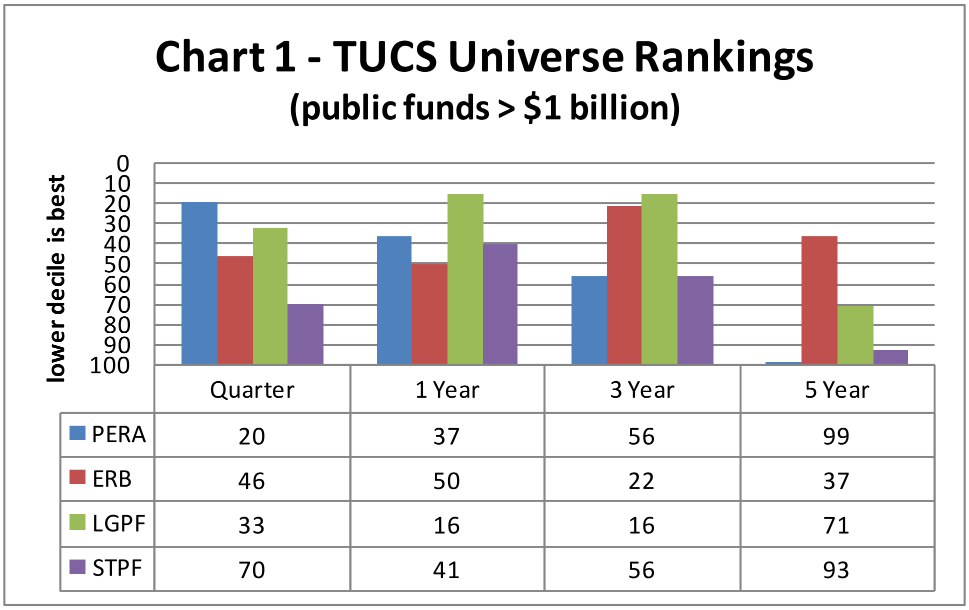
Table 1 shows ending balances and compares the investment agencies' percentage returns for the quarter and the one-year, three-year, and five-year periods with the S&P500. The returns and balances of the Severance Tax Permanent Fund (STPF) and Land Grant Permanent Fund (LGPF) are shown separately. A portion of the STPF is invested in economically targeted investments that yield below market returns; the LGPF does not have economically targeted investments in its portfolio and so is a better gauge of SIC's performance. The difference in return between the two is a rough approximation of the opportunity cost of these initiatives. For the quarter ending September 30, 2012, economically targeted investments cost the state approximately $20 million in foregone income.

Table 1
Returns and Ending Balances as of September 30, 2012

Returns (%)	PERA	ERB	LGPF	STPF	S&P 500
Quarter	5.05	4.58	4.77	4.22	6.35
1-Year	16.64	15.96	18.07	16.28	30.18
3-Year	9.30	10.14	10.25	9.47	13.2
5-Year	0.36	2.79	1.69	0.65	1.05
Ending Balance ($B)	12.224	9.758	11.244	3.993	

Source: Agency Investment Reports

Chart 1 shows peer total return rankings for the agencies' large funds for the quarter, annually, and over a three year period. A lower rank (1st is best) denotes a better performance when compared to other funds. All of the comparisons are made using the Wilshire Trust Universe Comparison Service (TUCS), a benchmark for the performance and allocation of institutional assets that includes approximately 64 public funds with more than $1 billion in assets.



	Quarter	1 Year	3 Year	5 Year
PERA	20	37	56	99
ERB	46	50	22	37
LGPF	33	16	16	71
STPF	70	41	56	93

For the quarter, PERA ranked in the 20th percentile, better than their longer-term results. It's five-year ranking is at the bottom of all funds in the universe. ERB returned a performance near the middle of all funds in the universe, consistent with their one-year performance. Its three-year performance remains good, landing in the top quartile. The funds invested by SIC fared differently, as indicated by the top-third quarterly ranking of the land grant permanent fund, which experienced very good one-year and three-year periods. The severance tax permanent fund, meanwhile, ranked in the bottom third in the quarter, in contrast to its middling rankings in the one- and three-year periods. Over five years, the STPF ranked in the last decile.

Attribution Analysis. There are three basic ways that a fund's returns can differ from the average: the policy, allocation, and manager effects.

Quarterly Policy Effect. A fund can have a long-term policy allocation (known as the "policy index") target that has a more or less aggressive proportion of risky assets such as stocks. For example, risky domestic assets such as US stocks (equities) performed best in the first quarter. Accordingly, an index that has more domestic equities should outperform the average. Measured in isolation, such a change in performance is known as the "policy effect," and it is an essential responsibility of the fund's trustees. The most appropriate measurement of a policy allocation benchmark is comparison to a defined peer group.

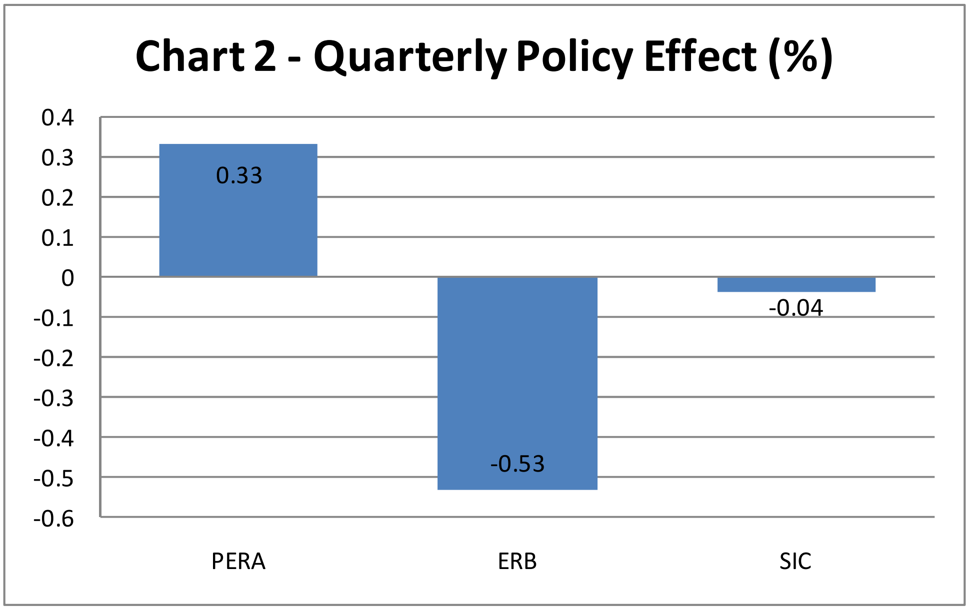
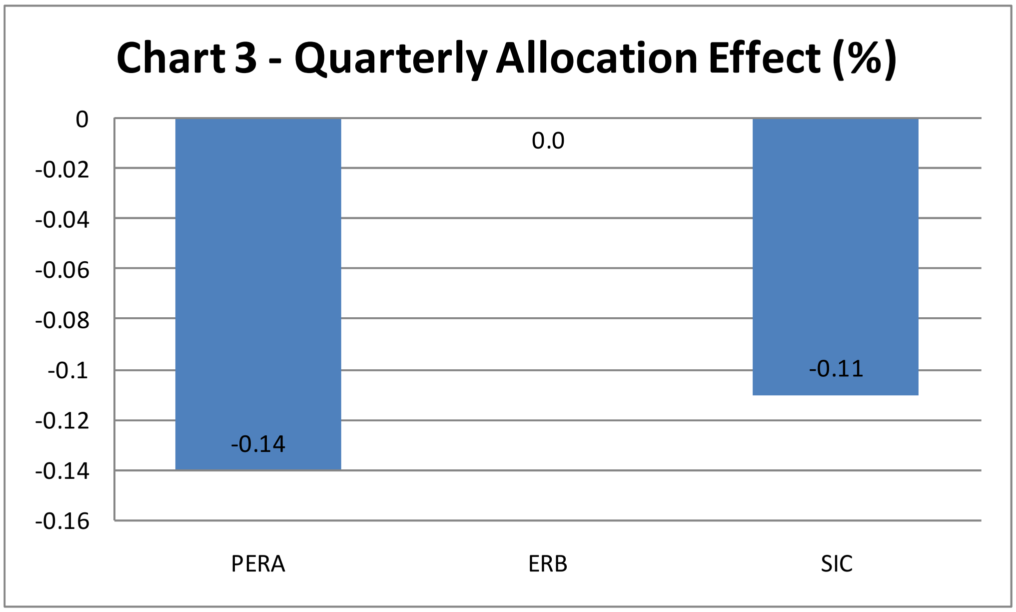


Chart 2 shows the funds' policy effect as measured by comparing the funds' policy indices to the TUCS median fund actual return. The TUCS median return is gross of the allocation and manager effects, and the measure is therefore a rough estimate of the policy effect. However, this report uses the TUCS for this measure to allow uniformity and consistency across the three funds. In isolation, PERA's policy allocation yielded 33 basis points more than the median fund because their policy calls for more equities (27 percent domestic and 27 percent international) than does the median fund. The SIC's LGPF policy calls for a 37 percent allocation toward domestic equities, and a 15 percent allocation toward non-U.S. equities. The SIC's policy allocation delivered returns 4 basis points below the median fund. It should be noted that SIC is undergoing a restructuring of its investment portfolio that includes a change in its asset allocation policy to a more conservative exposure toward U.S. equities in favor of less volatile assets. In contrast to both PERA's and SIC's policies, ERB's policy calls for a lesser exposure to equities (40 percent) in favor of fixed income assets. This less risky policy contributed to ERB policy index performing 53 basis points below the median fund performance during a quarter when the market rewarded risky assets such as equities. Also noteworthy is that the policy effects for all three agencies differ from the previous quarter, when the market did not reward risk.

Quarterly Allocation Effect. The second way that a fund's return can be affected is by tactically shifting assets away from the proportions called for by policy. This is a measure of the value added from a chief investment officer. For example, an investment officer might have had a bearish view of the stock market during the second quarter and used his authority to temporarily reduce a fund's risky assets to less than what is specified in policy. Because stocks had a strong quarter, increasing risky assets would have been a good market call and would have contributed to fund performance. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes. The investment officer may have the option of letting the money sit in cash or incurring the cost of temporarily covering the allocation through the futures market or some other avenue, depending on policy authority. It is important to note that tactical investment authority afforded the chief investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

The difference between the funds' temporary and long-term allocation is known as the "allocation effect" and is interpreted as investment return added or lost. Chart 3 shows the quarterly effect graphically; no funds gained value by deviating from their policy index. PERA lost 14 basis points from the market effect of underweights in international equities and private equity and from holding more cash than called for in its policy. ERB's return was not affected by temporary deviations from its policy allocation; and SIC's return was 11 basis points lower due to deviations from policy by being overweight fixed income assets and cash and from being underweight in real estate and foreign equities. Allocation gains or losses occur constantly – asset proportions vary against targets because of market price changes and incoming and outgoing cash flows, which are also variable.

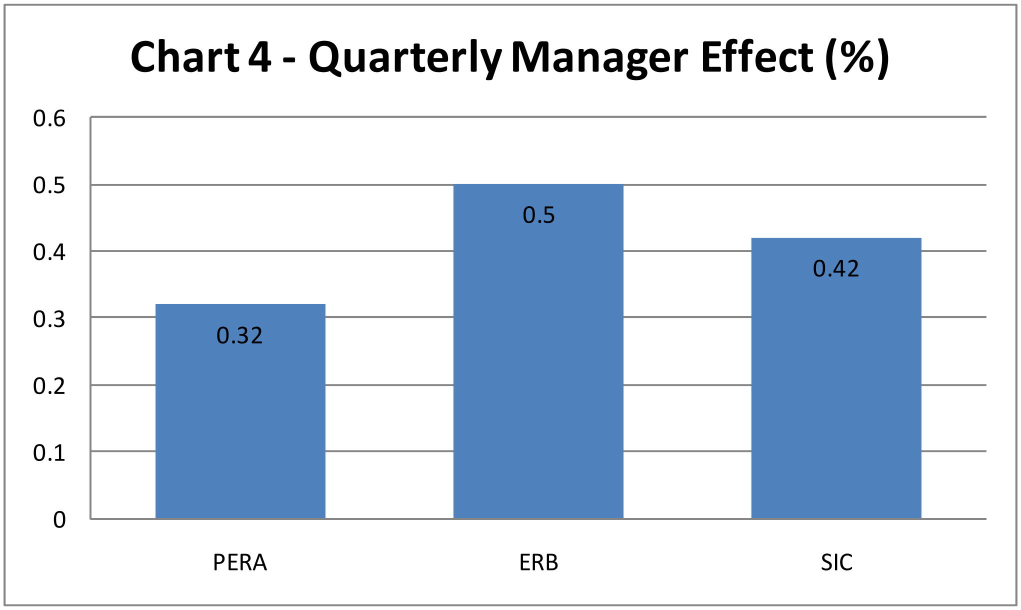


Quarterly Manager Effect. The third way that value can be added or subtracted from a fund is through the use of active management. For example, a fund can buy a security such as the institutional version of the Standard & Poor's Depository Receipts (SPDRS) commonly used by retail investors. These securities are composed of a relatively fixed basket of securities that track the S&P 500 index. Alternatively, the fund can employ a manager who will trade individual securities given his attitude about the prospects of individual stocks. This is known as "active" investing. The difference between the return of the index and the portfolio of the active manager is known as the "manager effect".

As Chart 4 shows, all three investment agencies had positive manager effects for the quarter. PERA's managers added 0.32 percent to returns, ERB's managers added 0.5 percent, and the SIC added 0.42 percent[1]. The majority of the value added by the SIC's managers was in the fixed income, private equity, and U.S. equity asset classes, while the managers' stock selection in the foreign equity asset class resulted

[1] The SIC notes that its net-of-fees performance analysis is based upon an estimate of SIC's investment performance developed by RV Kuhns.

in lost value. The SIC notes that it is in the process of replacing its external managers as a result of its portfolio restructuring. Among the changes is a transition to more external management, which SIC explains is due to understaffed in-house management, reducing the size of the in-house portfolio from $4 billion to $400 million.



The market environment and the funds' quarterly performance can be summarized as follows:

- Stocks rallied in the third quarter thanks to collective monetary easing by central banks in the U.S. and Europe.
- In the U.S., the S&P 500 Index gained 6.4%, compared to losses of 2.8% in the second quarter.
- International markets posted returns of 6.9% during the quarter, compared to losses of 7.3% in the second quarter.
- Using the TUCS, it is possible to rank the funds against the same universe.
- PERA's return was above average for the quarter. A strategic asset allocation that emphasizes equities put the fund at an advantage in a quarter where stocks performed well. PERA's lost value due to deviation from long-term allocation targets due to market impact was eclipsed by the value added by its active investment management, resulting in gains of 5.05 percent.
- ERB turned in a middling performance as their emphasis on less risky assets resulted in foregone gains in the quarter. Deviation from policy allocations had no effect, and managers added 50 bps to returns, net of fees.
- SIC quarterly performance was in the top third of peer funds. The investment agency's portfolio was slightly less exposed to domestic and international equities, which rallied in the quarter, resulting in a small negative policy effect. Slight value lost from deviation from the policy allocation targets was more than offset by value added by the agency's managers, contributing to quarterly investment returns of 4.77 percent.